

RUSSIA: FAST STARTER
HOUSING SECTOR REFORM
1991-1995

Prepared by

Nadezhda B. Kosareva
Alexander S. Puzanov
Maria V. Tikhomarova

The Urban Institute
2100 M Street NW
Washington, DC 20037

Project 06306-009
June 1995

Prepared for

Housing Sector Reform Project, Russian Federation/City of Moscow
Project 110-0008
U.S. Agency for International Development, ENI/EEUD/UDH

ABSTRACT

Russia has achieved significant accomplishments in its housing reform program, starting with the passage of the housing privatization law in July 1991 and continuing through early 1995. Policies have been adopted to establish the legal framework necessary for transformation of the housing sector to one operating under market principles. Substantial progress has been made in the area of housing production, finance, home ownership subsidies and the rental market. However, additional legislation is needed in mortgage finance, land, and other areas that still hinder the expansion of the private sector.

EXECUTIVE SUMMARY

As recently as 1991, the Soviet Union may have had the most regulated housing market in the world. This was the result of a policy of "state paternalism" directed at maximum socialization of housing, and the near-exclusion of market forces from the housing sector. In mid-1991, the Soviet Union (later the Russian Federation) began the daunting task of reorienting the housing sector to market principles. The gains from improved efficiency would have a major impact on the economy because of the size of the sector. Improving housing conditions would also significantly improve the quality of life of the average citizen.

This paper records accomplishments in the housing reform program—starting with the passage of the housing privatization law in July 1991—through early 1995. The achievements are perhaps surprisingly extensive, and certainly compare favorably with any country in Eastern Europe.

Housing reform in Russia is characterized by three distinct phases. The first started at the end of 1990, with laws initiating the reallocation of housing property and, therefore, a change in the responsibility for decisionmaking in this sphere. It also included laws on privatization, which established procedures for the transfer of state and municipal housing into the private ownership of tenants. The second phase of housing reform dealt with the adoption of legal acts which determined the direction of housing reform and policy. The third period of housing policy (1993 to autumn 1994) may be characterized as the stage when housing regulation was adopted and its implementation started.

n Housing Needs and Production. In 1992 Russia ranked last among industrially developed nations in terms of the amount of housing space provided (as measured by floor area). The lack of housing space was worse in cities than in the country side, where the main concern was the condition of the housing stock. Housing construction in Russia reached its peak in 1987, after which it has been falling annually (except in 1993 when it maintained the 1992 level). Although production has fallen, the main development in this area has been the changing types of property owners and investors in new construction. Municipalities now commission new housing (not the national government), and there is a large number of private customers, who in 1994 accounted for 28.6 percent to the total volume of construction.

Overall we can state that a reduction in the volume of new construction has been accompanied by an increase in the quality of new housing. Market demand is being satisfied by private developers who have emerged as major new players. When conditions have improved so that individuals may more easily act as their own general contractor, this type of construction will become even more important. The main obstacles hindering expansion of the private sector are the lack of regulation of the registration of ownership, problems of land ownership, and the absence of bank financing during the construction period.

n Housing Finance and Home Ownership Subsidies. Prior to 1993, the housing finance situation in Russia was characterized by extremely ineffective use of subsidies, high and volatile interest rates, grave credit risks associated with housing lending and extremely low housing affordability. The new objectives of the housing finance policy initiated in 1993 have not yet been fully realized—neither from the legislative and regulatory point of view, nor in the practical implementation of the new policy. The problem of foreclosure and eviction in the case of loan default remains a central sticking point. However, substantial progress has been made in initiating

mortgage lending, and in the areas of interest rate risk, loan affordability, credit risk and funds mobilization.

n *Rental Housing.* In January 1994 the government began implementing a program of raising rents to cover full operating costs combined with the introduction of housing allowances. The final goal of the approach is to raise rents to market levels. However, much needs to be done in the private rental market where the magnitude of stock is still very small, despite the absence of rent controls and substantial privatization of housing units.

In conclusion, the three years of reform implementation (1992-1994) have resulted in significant changes in the housing sector. The Russian Federation has acted with dispatch to create much of the legal framework necessary for transformation of the housing sector to one operating under market principles. While additional legislation in mortgage finance and land is needed, as well as the Housing Codex for the Russian Federation, much can be done—and has been done—within the current legal foundation.

RUSSIA: FAST STARTER HOUSING SECTOR REFORM 1991-1995

Introduction

As late as 1991, the Soviet Union may have had the most regulated housing market in the world. This was the result of a policy of "state paternalism" directed at maximum socialization of housing and the near-exclusion of market forces from the housing sector. The key principles of this policy were:

- | Centralized distribution of all resources and strictly formalized planning of the volume and distribution of new housing construction;
- | Use in practically all regions of the country of standardized multi-floor building construction plans, with the housing constructed by a small number of large kombinants;
- | Extreme state monopolization of the construction industry and housing maintenance facilities;
- | Financing of all state housing construction exclusively from centralized assets of the state budget or state-run enterprises;
- | Near-total subsidization of housing and maintenance organization activity through various forms of state funding;
- | A constitutional guarantee of housing provision at a low cost (strong rent controls);
- | A dominant role for the state-operated system for distribution of housing through local waiting lists.

Thus, the goal of housing policy was almost completely directed toward the establishment and development of only one form of housing: state-owned units.

Although informal, implicit market relations existed, generations of regulation had almost completely replaced normal market relations in the production and allocation of housing. In mid-1991, the USSR, and then the Russian Federation, began the daunting task of reorienting the housing sector to market principles. The potential gains from succeeding are enormous. The housing sector was evaluated in the famous "Five Hundred Days" Shatalin report as the least efficient sector in the economy—measured as the ratio of the cost of inputs to the price of outputs. Improving efficiency would have a major impact on the economy because of the size of the sector. Housing stock accounts for 20 percent of the nation's reproducible wealth; housing investment is about 26 percent of all investment; and 13 percent of the labor force is employed in housing construction and maintenance. Improving housing conditions would also significantly improve the quality of life of the average citizen.

This article inventories accomplishments in the housing reform program—starting with the passage of the housing privatization law in July 1991—through early 1995. The achievements are

perhaps surprisingly extensive, and certainly compare favorably with any country in Eastern Europe.

Housing reform in Russia started at the end of 1990 with the Law "On Local Self-Government in the RSFSR." The law introduced the concept of municipal property of the district/city, as well as in its administrative and territorial units. This concept was later confirmed in 1991 by the Law "On Property in the RSFSR." Thus the first period of housing reform initiated the reallocation of housing property and, therefore, the change in responsibility for decisionmaking in this sphere.

The policy was declared to municipalize part of the state housing stock, engineering and utility infrastructure, as well as housing maintenance and repair enterprises and construction organizations servicing this stock and utilities. The main incentive of this strategy was the transfer of housing maintenance to a lower level, and, therefore, the release of federal budget funds. However, the main result—decentralization of decisionmaking—has considerably exceeded the goals.

Today the Subjects of the Russian Federation and municipalities have considerable freedom of action in the realization of housing policy, and the sphere of housing legislation is in the joint competence of the Russian Federation and the Subjects of the Federation (in accordance with the Constitution of the RSFSR as of 1993).

In the summer of 1991 the Supreme Soviet of Russia adopted the Law "On Privatization of the Housing Stock in RSFSR," which established procedures for transfer of state and municipal housing into the private ownership of tenants. Later amendments to the law transformed it into one where privatization of the housing stock was completely free of charge. The necessity of achieving an immediate transfer of a considerable part of the housing stock into private ownership in order to create the basis for forming the housing market outweighed arguments concerning the social injustice of such a reallocation of property.

As of the beginning of 1995, 36 percent of the housing stock subject to privatization at the beginning of the housing reform had been privatized and more than 53 percent of the entire housing stock is in private ownership. The rate of privatization reached its peak in the summer of 1993, and at present is slowing down. The necessity of establishing a time limit for the period of free-of-charge housing privatization is becoming more actively discussed.

The second period of housing reform is connected with the adoption of a legal act which determined the directions of housing reform and policy (the law "On Foundations of the Federal Housing Policy" of December 1992). The law established the following basic principles and goals:

- 1 The concept of "real estate" was introduced (though only as "real estate in the housing sector"). This led to the legalization of land plots;
- 1 The right of citizens' ownership for housing without limiting its size;

- | Local governments are now required to provide individuals and developers with plots of land for housing construction within one month and two months, respectively, on terms to be determined by the local government;
- | Provisions enabling condominiums;
- | Reform of the payment system for municipal and state leased housing, providing for step-by-step transition during five years to full coverage of expenses for current maintenance and repair of housing at the expense of tenants;
- | A system of housing allowances for housing and utilities payments, to support low-income families ability to pay for housing of the appropriate stipulated social standard;
- | Mandatory competition in the procurement by state bodies of maintenance services, rehabilitation, and new construction of housing.

In June 1993, the state program *Zchilische* or "Housing"¹ was adopted, with detailed plans for government implementation of aims and principles for housing policy during the transition period. The program was largely derived from the contents of the major pieces of legislation already enacted, but it also outlined new policy initiatives.

The program is distinguished by its attempts to achieve objectives through the generation of financial resources. Non-budgetary funds (including bank credit resources, savings of individuals and funds of enterprises) were identified as the main financing source to develop the housing sector. Thus, the *Zchilische* program concentrates on the development of new ways of financing housing construction and attracting non-budgetary investments in it, namely: development of mortgage housing lending and a system of individual savings accounts, and the introduction of a special bond market for housing securities—housing certificates, municipal securities, and local housing construction funds.

The state has committed itself to finance housing exclusively for certain strictly limited groups of inhabitants. For example, housing construction is budgeted for servicemen (including retirees), liquidators of the Chernobyl catastrophe, migrants from the Far North, and a limited number of other groups.

Under the program, housing construction for other types of persons on the waiting list for municipal and state rental housing should be financed by local budgets and enterprises. In practice, it is getting more and more difficult to sustain the distribution of such housing because funds for new construction are not available.

To use the extremely limited budget funds for new housing construction more effectively, the *Zchilische* program defines two basic directions of the reform:

Council of Ministers Decree, No. 595, June 20, 1993.

- (1) The transition from interest rate subsidies for housing construction for certain groups of inhabitants and total subsidizing of housing construction for persons on the waiting list to a new system of down payment subsidies. The subsidy amount depends on the family's income (inversely proportional) and on the number of years the family has been registered on the waiting list (directly proportional); and
- (2) Reforming of the system of housing rents (through rent increases) to stimulate the redistribution of the existing housing stock for more effective use.

The third period of the housing policy (1993 through autumn 1994) may be characterized as the stage when housing regulation was adopted and its implementation started.

The Resolution of the Government of the Russian Federation for the transition to the new rent system and introduction of housing allowances was adopted in September 1993. The implementation of the program was started throughout the country on January 1, 1994.

In December 1993 and June 1994 the President of the Russian Federation signed two sets of Decrees. These included programs and regulations on attracting non-budget resources for housing finance, bank loans to citizens, the provision of budget subsidies for construction and purchasing of housing, procedures of issuing and circulation of a special housing bond (a "housing certificate"), and principles for founding condominium associations.

The Ministry of Construction adopted a normative document on the procedures for holding competitions among contractors to provide housing maintenance services for state or former state housing still assigned to municipalities or enterprises. There are 100,000 apartments (3 percent of the housing stock) in Moscow today which are maintained by private companies, chosen on a competitive basis. Other cities (Ryazan, towns in the Nizhny Novgorod oblast) have followed the example of Moscow.

Despite all the changes initiated, the housing reform process has not yet become dominating and irreversible. Many reforms are in the stage of a demonstration project or the design of the first applicable models. We think there are four main reasons for this:

- (1) Some problems are not addressed by the law (for example, foreclosure on property), impeding the development of mortgage lending;
- (2) In some cases, in spite of the existence of legislative and regulatory provisions at the Federal level, corresponding regulatory documents have not yet been adopted at the level of the Subjects of the Federation (e.g., oblasts) and the local level (for example, documents concerning the foundation of condominiums, or demonopolization and transition of housing maintenance on the competitive basis);
- (3) The implementation of some kinds of reforms (for example, the development of long-term housing lending) are impeded by the extremely unfavorable economic situation of high inflation; and

Table 1 (4) The existence of constant opposition and counteraction to implementing housing reform. Opponents of housing reform constantly point to "guaranteed" free-rent housing as one of basic achievements of socialism. Conservative public forces have also succeeded in impeding the reform process.

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|--|------|------|------|-------|--------|---------|---------|
| GDP (billions of rubles, nominal prices) | 553 | 578 | 644 | 1,300 | 18,063 | 162,311 | 630,000 |
| Annual change of real GDP (percent) | | 4 | 3 | -2 | -12 | -19 | -12 |

In December 1992 when general economic reform had strong momentum, the Seventh Congress of People's Deputies passed two amendments to the Constitution of the Russian Federation critical for housing reform. Article 58, dealing with the *rights of citizens to housing* at a low price, was replaced with a much more market-oriented variant. In part, the new article stated that the state's obligation to provide housing can be satisfied by the household's purchase or construction of housing at its own expense, the provision of housing through the traditional *naim* (social housing) contract, through payment of housing allowances, or subsidies for construction, maintenance or rehabilitation of housing.

The housing provisions of the new constitution (Article 40 passed in December of 1993) reaffirms the right to housing and state that the federal and lower levels of government "encourage housing construction and create the conditions for exercise of the right to housing." The final provision, however, gives the state the task of providing housing "free or at affordable cost to low-income and other citizens indicated in the Law...." This represents a significant shift from the amendments to the constitution a year earlier in the direction of reasserting state responsibility. Thus far, this provision has not affected specific policy measures, but it could be used by those wanting to veer away from market-oriented reform.

Our general conclusions can be succinctly summarized. The Russian Federation has acted with dispatch to create much of the legal framework necessary for transformation of the housing sector to one operating under market principles. While additional legislation in mortgage finance and land is needed, as well as the Housing Codex for the Russian Federation (which would implement many provisions of the "Law on Fundamentals"), much can be done—and has been done—within the current legal foundation.

Economic Trends

In the past, housing policy in Russia was never fully integrated with macroeconomic reforms. This is unfortunate since rational changes in the housing sector can not only serve directly as part of the new economic system but can also serve the principal needs of macroeconomic stabilization.

Macroeconomic conditions for carrying out housing reform are determined first and foremost by the overall crisis in the Russian economy of the last few years. This crisis has produced a sharp reduction in the volume of production, a reduction in the population's standard of living, and the appearance of catastrophic inflation. The crisis is reflected in the dynamics of the Gross Domestic Product (GDP), as shown in Table 1.

The decline in GDP started in 1990 when, for the first time since 1945, GDP fell 2 percent compared to the previous year; the maximum reduction of GDP was observed in 1992 (a 19

percent decline from the 1991 level). In 1993 the situation in some sectors of economy was somewhat improved, though overall the economic recession of the previous years continued and GDP in 1994 fell a further 15 percent. If we compare the 1993 GDP of Russia and of the U.S., we see that the aggregate GDP of Russia amounted 13.6 percent of the U.S. GDP; on a per capita basis, GDP per head in Russia is only 23.6 percent of the U.S. measure. Against the background of this constant and considerable reduction of production of goods, 1994 saw growth established in various services inherent to the market economy (banking, accommodations, insurance services, and financial intermediaries and real estate agencies).

Liberalization of prices in January 1992 is regarded as the starting point of real economic reform. By the beginning of 1993, 80 percent of all prices were freely set in the market, compared to only 20 percent in 1991 and 5 percent in 1990. During 1993-1994 price regulation was scaled back even further. With the decontrol of prices in 1991 came inflation, when the consumer price index rose to 2.40 from the level of 1.03 to 1.05 seen in all previous years. Inflation peaked in 1992, with prices increasing 15.6 times over their 1991 levels. According to data from the Russian Federation Pricing Committee, in the first six months of 1992, the consolidated index of prices and tariffs for goods and services rose 475 percent. The corresponding index of housing and communal services rose 291 percent (increasing prices affected only communal services while rents were unchanged).

Since 1992 inflation has surged and receded again and again. In 1993 the rate of inflation slowed down somewhat. The consolidated index of prices and tariffs for goods and services increased 9.4 times compared to its 1992 level. In the first half of the year monthly inflation fell from 26 percent in January to 18 percent in May, but by August it again increased to the level of January. The last increase was spurred by liberation of coal prices, an increase in purchase prices for agricultural products of the new harvest, and the Central Bank providing the Government with loans to cover the budget deficit and supporting significant branches of industry with cheap funds. On the whole in 1994 there was considerable slowing down of price increases compared to 1992-1993. Monthly inflation was about 10 percent (compared to a monthly average of 21 percent in 1993).

Looking at incomes and expenditures of the population, from 1988 to 1991 the growth of expenses corresponded to the growth of incomes. In 1992 surging expenditures were accompanied by a sharp relative reduction of incomes. For example, by October 1992 consumer prices for goods and services had grown by 16.8 times in comparison with December 1991, while factory and office worker wages rose by only 7.7 times. This result is connected first with the tough financial policy of the Government, directed toward reducing the Federal budget. In 1993, while continuing the same policy, the Government started to make arrangements to stabilize living standards and to enhance support of socially unprotected sections of population. The implementation of this policy was started with the help of the following basic instruments: regulation of the minimum income level through fixing the minimum rates of wages, pensions, subsidies; state support of the social sphere; and financing of top priority federal social programs. As a result, money incomes of the population (70 percent of which consists of wages) increased a faster than prices for goods and services. In 1994 disposable money income relative to the consumer price index increased by 15.6 percent. Nevertheless, the level of real disposable money incomes was 30 percent lower than in 1991. There were changes in the household income

distribution, driven by a considerable increase of incomes from business, property, and finance-loan operations.

Privatization of the means of production is one of the most controversial aspects of reform, and it truly began only in 1992. By November 1992, for example, industry was less than 4 percent privatized; the corresponding figures for retail and household services are 7.75 and 6.50 percent, respectively. By January 1994, 89,000 enterprises were privatized. By the end of 1993 the share of private sector and enterprises of other non-state forms of property constituted 46 percent of services and 75 percent of trade turnover volume. In 1994 a predominant part of the GDP was manufactured in the non-state sector of the economy. By contrast, in 1991, 96 percent of GDP was state-produced. One may draw the conclusion that privatization in Russia advanced at a rather brisk pace, driven by the mass "voucher privatization" program.

In 1994 the first—voucher—stage of privatization was completed. By the end of the year 100,000 enterprises were privatized and 18,600 more had applied for privatization. Reorganization in the form of joint-stock companies came to be the most widespread form of privatization. There were three options for distributing a firm's shares. The most common (61 percent) resulted in workers and management of the firm obtaining a controlling interest. Hence, some critics wonder if the incentives faced by such enterprises have really changed. In the winter of 1994-1995 the second stage of privatization began in which firms sell shares for cash on the open market. This phase could have more profound effects on firms by giving them an infusion of cash and changing the composition of the boards of directors.

The Housing Situation at the Beginning of Transition

The housing situation in Russia's initial phase of economic reform reflects the continuation of a housing crisis that has existed for many years.

The main indicator used for establishing norms, calculating statistics, and making predictions was the "level of housing space provided." This figure, still 16.7 square meters per person as of 1992, placed Russia among the lowest ranking of the industrially developed nations.² Some 31 percent of families and single persons had less than 9 square meters per person, lower than the officially established minimum in the first years of Soviet power.³

The lack of housing space was worse in cities—16.0 square meters per person—than in the countryside (18.4 square meters per person).⁴

Goskomstat of the Russian Federation, *The Russian Federation in Numbers—1992: A Brief Statistical Collection*, Republican Information and Publishing Center, Moscow, 1992.

Economic Opportunities, Moscow, 1992. Center for Economic Conditions and Forecasting. Russia, 1992.

Goskomstat of the Russian Federation.

Table 2 If one looks at housing availability based on a more informative indicator—type of housing—then according to census data for 1989, 60 percent of families and single persons were living in separate living units—apartments, individual houses or portions of individual houses.⁵ All others were living in communal apartments (apartments with a common kitchen and bath and toilet for several families) or territories of territorial ownership not have any permanent dwelling.

| | Total | Urban | Rural |
|-------------------------------|-------|-------|-------|
| Total housing stock | 100 | 100 | 100 |
| State-owned, including: | 67 | 79 | 37 |
| Agency-owned | 42 | 44 | 35 |
| Owned by local Soviets | 25 | 35 | 2 |
| Public (e.g., trade unions) | 3 | 1 | 9 |
| Housing cooperatives | 4 | 5 | 6 |
| Personal property of citizens | 26 | 15 | 54 |

If the problem of the city dweller was the quantity of housing and the availability of separate units, the rural resident was mainly concerned with the condition of the housing stock. The quality of housing had a tendency to be in proportion to the size and category of population center. The state policy of industrialization and development of large urbanized industrial zones totally ignored the problems of forming an engineering infrastructure in the small cities and rural population centers. As a result, while every fifth house in cities and towns is without running water, sewage or central heating (80-90 percent of the individually owned housing stock lacks these amenities), in public housing in the countryside this figure is 55-60 percent of all apartments.⁷

It should be noted that the Russian housing stock is relatively new: 89 percent of all dwellings have been built in the last 40 years.⁸ Even though official statistics state that only 1.2 percent of the housing stock is in dilapidated or condemned condition,⁹ the overall technical condition of the housing stock can be characterized as very bad. Funds for capital repair provide only half the repairs actually required.¹⁰

One element that sets housing in Russia apart from that in other Eastern European countries is the implementation of a policy of maximum government control of housing (Table 2).

Center for Economic Conditions and Forecasting (1992).

N. Kosareva, O.S. Pchelintsev and G.S. Ronkin, "On the Road to Housing Reform: Analysis and Prognosis," in *Voprosy Ekonomiki (Economic Problems)*, No. 33, 1990.

Goskomstat of RSFSR, *Consolidated Report on the Housing Stock and Total Number of Persons Inhabiting It at the End of 1990 (Part 1)*. Republican Information and Publishing Center, Moscow, 1991.

Center for Economic Conditions and Forecasting (1992).

Goskomstat of the Russian Federation, *Several Socio-economic Indicators of the Situation of the Russian Federation for January-October 1992*. Republican Information and Publishing Center, Moscow, 1992.

Goskomstat of the RSFSR, *The RSFSR Economy for 1990, Statistical Annual*. Republican Information and Publishing Center, Moscow, 1991.

Table 4 Housing Constructed Using All Sources of Financing
Total Governmental Housing Constructed Using All Sources of Financing

| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|------|------|------|------|------|------|------|------|
| New housing constructed (millions of square meters) | 72.8 | 72.3 | 70.4 | 81.7 | 49.4 | 41.5 | 41.8 | 38.9 |
| New housing constructed (percent of 1987 level) | 100 | 99 | 97 | 85 | 68 | 57 | 57 | 53 |

Sources: Goskromstat of Russia.

It should first be noted that the "policy of government paternalism," in spite of all the propaganda to the contrary, was strictly limited to certain portions of the population. In reality, only city dwellers had access to state housing, with more than half the rural population left to its own devices.

City dwellers who did not fall into the official category of needing housing improvements because they had more than the established minimum space (usually 5-7 square meters per person), were in much worse shape. In the old system such families were not eligible for any official improvement in living conditions even if they were living in terrible conditions and other quarters were available. Furthermore, in large cities, where more than 63 percent of the urban population live, individual housing construction was forbidden from 1961 until 1988. According to our data the proportion of the populace that was ignored by state housing policy totalled no less than 40 percent of the population.

In only four years, in which actual reform took place only in three, the situation regarding ownership rights changed dramatically (see Table 3). Even by 1993 (the second year of reform), the share of state owned housing stock was only 20 percent; the share of privately owned housing reached 55 percent.

| Form of Housing Ownership | Housing Stock (percent) | | |
|--|-------------------------|-------|-------|
| | Total | Urban | Rural |
| Total housing stock | 100 | 100 | 100 |
| State-owned | 20 | 22 | 13 |
| Municipal | 27 | 36 | 4 |
| Public (e.g. trade unions, collective farms) | 2 | 1 | 4 |
| Private property of citizens | 39 | 27 | 72 |
| Mixed form of property | 8 | 9 | 5 |

Goskromstat of the Russian Federation, *The Russian Federation and Regions of the Central Black-soil Region in 1991*. Republican Information and Publishing Center, 1992.

Table 6 briefly in 1993; during that year housing with the total floor space of 41.8 million square meters (53 percent of the 1987 level). Units 1991 Unit Size 1993 Production
 Housing Units Constructed 1980-1990 Type 1994
 However, in 1994 the situation reversed again, and the volume of commissioned housing fell to 38.5 million square meters (53 percent of the 1987 level). Units 1991 Unit Size 1993 Production

| | 1980 | 1983 | 1987 | 1989 | 1990 | 1991 | 1993 | 1994 |
|--|--------|--------|--------|--------|--------|--------|--------|--------|
| Total | 1,190 | 1,151 | 2,207 | 1,221 | 1,044 | 851 | 882 | 895 |
| Total | 38,467 | 38,467 | 38,467 | 38,467 | 38,467 | 38,467 | 38,467 | 38,467 |
| State, includes: | | | | | | | | |
| Federal | 10,648 | 10,648 | 10,648 | 10,648 | 10,648 | 10,648 | 10,648 | 10,648 |
| Municipalities | 8,507 | 8,507 | 8,507 | 8,507 | 8,507 | 8,507 | 8,507 | 8,507 |
| Housing cooperatives | 1,392 | 1,392 | 1,392 | 1,392 | 1,392 | 1,392 | 1,392 | 1,392 |
| Private persons | 4,142 | 4,142 | 4,142 | 4,142 | 4,142 | 4,142 | 4,142 | 4,142 |
| Selling forms | 61 | 61 | 61 | 61 | 61 | 61 | 61 | 61 |
| Organizations | 73 | 73 | 73 | 73 | 73 | 73 | 73 | 73 |
| Private firms, includes: | | | | | | | | |
| Figures for state enterprises and organizations housing cooperatives and private persons | | | | | | | | |
| consolidated for 1988 and 1989 | | | | | | | | |
| Mixtures include data for state and municipal construction | | | | | | | | |

Notes: Goskomstat of the Russian Federation, *The Russian Federation in Numbers—1991, A Brief Statistical Yearbook*, 1991, Moscow, 1992; *The Russian Federation in Numbers—1993, A Brief Statistical Collection*, Republican Information and Publishing Center, Moscow, 1994.

In 1989, the main customers for new construction were the state (municipalities) and state enterprises and organizations; together they accounted for 80 percent of the total volume of new housing completed in 1990 (see Table 5 on the next page). In later years, due to the substantial state budget deficit and the start of the privatization process, state organizations, municipalities and enterprises played an increasingly smaller role; by the end of 1994 their contribution amounted to 41 percent of newly constructed housing. Although the total volume of construction is decreasing, a positive trend has been preserved in private sector housing construction. In 1994 individual families built 77,000 residential units with the total space of 7 million square meters—19 percent more than in 1993. The rate of construction for housing construction cooperatives, *kolkhozes* (cooperative firms), and cooperative and lease-based enterprises went down slightly.

A hallmark of the transition has been the changing types of property owners and investors in new construction. Municipalities now commission new housing (not the state or national government). State enterprises have shifted in very large numbers to private status thanks to the industrial mass privatization program. These developments, plus the co-financing of projects by different types of entities, makes tracking housing investment by source very difficult.

Table 6 provides data on the structure of newly completed housing by the ownership of the entity acting as the customer or investor for the completed units.

At present, federal financing is going mainly to targeted-use housing: for persons in military service, personnel of internal affairs bodies, victims of the Chernobyl catastrophe, and reprisal victims. In 1994, 44,000 apartments with a total floor space of 2.7 million square meters were built

for families of servicemen, personnel of the internal affairs bodies, and persons subject to resettlement from closed military units.

In 1994 the volume of housing construction by the municipalities for low-income families was also reduced (74 percent of the 1993 level). The main reasons lie in high construction costs and limited budget funds. As a result, the municipalities are changing their policy and turning to the construction of housing for sale to individuals. According to Moscow's housing program, for example, in 1995 social housing should amount to 58 percent of total housing construction (including housing sold to some organizations at cost), and consequently, 42 percent of new housing will be allocated for sale.¹³

One cannot but note the appearance of private customers, who in 1994 contributed 28.6 percent to the total volume of construction. Private customers are building primarily high-quality housing (brick blocks with improved-plan or custom designed apartments) in the prestige districts of large cities and "cottages" (detached, single-family units) in the suburbs. In Moscow and St. Petersburg private companies are also engaged in reconstruction of old buildings and erection of garrets.

More than 50 percent of the "private developers" are individual families, involved in self-construction. The removal of the ban on construction of such units in the large cities, a relative reduction in the red tape of land allocation, and the possibility of receiving land as personal property for constructing a single-family house helped increase such activity in the late 1980s. However, the sharp reduction in purchasing power has also had an impact on this type of housing construction. In 1993 the rate of such construction went down 3 percent, but 1994 was marked by a considerable increase (126 percent as compared to 1993), with the result that the share of such units in total new housing reached 18.2 percent. In the first quarter of 1995 the share of individual housing construction in the total (measured in square meters of floor space) was 24 percent.¹⁴ Nevertheless, there is a tendency for the increase to be hindered by lack of serviced sites and the high cost of construction materials.

A major share of new housing (32.7 percent) is built by the developers for a mixed type of ownership. This group mainly includes the so-called "shared participation construction" which has recently become wide-spread due to the lack of bank or equity financing for the construction of complete multi-family complexes. However, developers are faced with considerable problems in the registration of apartments upon completion of construction due to the absence of an established legal procedure. The problem could be solved by registration of such buildings as condominiums at the moment of construction. However, at present this is practically impossible.

Reduction in the volume of housing construction is explained primarily by a decrease in state financing and the low effective demand of the population due to the substantial increase in construction costs. In 1994 only 14 percent of total volume of housing *financing* came from

centralized capital investments (from federal budget and budgets of subjects of the federation). Similarly, centralized investments covered only 24 percent of housing stock erected by state enterprises and entities; the rest was funded by private investors involved in the construction project on a "share participation" basis. Future prospects are also not bright. The total volume of federal budget capital investment in 1994 equaled 2.6 trillion rubles.¹⁵ Federal budget estimates for 1995 spending for this purpose is 3.5 trillion rubles.¹⁶ Thus, considering anticipated inflation, the budget actually stipulates further reduction of federal spending on housing construction.

The price index for construction and installation work increased by 15.6 times in 1992 and by 11.9 times in 1993. By comparison, these prices rose only 400 percent during the previous seven years (1984-1991). In 1994 the rate of price increase went down slightly, but the actual increase in prices was substantial (5.5 times higher compared to the previous year). As a result, actual construction costs increased 2,200 times over their 1985 levels. Estimates of the cost of a square meter of housing in a large panel building show an increase from 260 rubles in 1985 to 800-1,000 rubles in 1991 to 830,000 rubles at the end of 1994.¹⁷

Due to the monopoly position of large construction enterprises and central design institutes, large multi-story prefabricated standard buildings of precast reinforced concrete were constructed all over the country. The only variety introduced in 35 years was a generation of four standard designs for these buildings. At present the share of new buildings using these designs is considerably lower than in the past, as the main investors for such housing are municipalities, ministries, and departments. Lower demand for precast large-block housing construction resulted in a decrease in the production of precast blocks and other such structures by 52 percent during January-February of 1994 compared to the same period in 1991. Today the most popular types of housing are brick apartment buildings with improved unit floor plans. One should also note the appearance of elite cottage settlements with full services (schools, supermarkets, sports facilities, security, and the like).

On the whole, the average size of a newly constructed unit has increased; in 1994 it reached 65 square meters of total space, compared with 59.1 square meters in 1990. The largest units are built by private, small developers and individuals (79 and 95 square meters, respectively; see Table 6), showing a demand by wealthy individuals for a new kind of housing. Less than half the apartments constructed by state enterprises and organizations were of this size. Individuals are now demanding the construction of single family houses with three, four, or more rooms (so-called "cottages"). However, access to urban services poses a problem for the individual developers—at present most of the cottages built in the suburbs of large cities have no central sewerage, water or gas supply.

Data of Ministry of Finance of Russia.

Attachment to the Federal Law "On the Federal Budget in 1995" — In Departmental Attachment to "Rossiyskaya Gazeta," 7.04.95.

Data from "Housing Indicators," and Ministry of Construction of the Russian Federation.

Overall we conclude that the reduction in the volume of new construction has been accompanied by an increase in the quality of new housing. Market demand is being satisfied by private developers who have emerged as major new players. When economic conditions improve so that more individuals can undertake housing construction and investment, this type of construction will become even more important. The main obstacles hindering expansion of the private sector are the lack of regulation of the registration of ownership, problems of land ownership, and the absence of bank financing during the construction period.

The December 1993 Russian Federation Constitution, the 1991 Land Code, and a host of Presidential decrees enacted since the winter of 1991 constitute the legal framework of laws related to land rights, allocation, and use. While this framework represents major progress in the area of land reform since the Soviet era of complete state ownership of land and centrally-controlled decisions, the current land reform does not allow widespread ownership of land and continues to tie property rights to land use designation made by governmental bodies. In December 1993 the first 23 articles of the 1991 Land Code were nearly entirely eliminated by Presidential decree.¹⁸ As a result, the authority to regulate land was taken from local administrations and left at the regional (oblast) level.

At present the main right to land is the right of long-term lease. Only land plots for individual housing construction, summer cottages, and farming can be conveyed into private ownership. Sale of idle land plots at auctions was permitted in 1993. However, private companies did not actively participate in such auctions as it was a lease right and not an ownership right that was offered for sale. Moreover, there are no legal acts governing leasing arrangements or protecting the rights of lessees.

Lastly, it should be noted that hundreds of residential construction projects were abandoned in 1992 and 1993 because of cutbacks in state funding. Government Resolution No. 59 permitted as of March 1992 the public auction of uncompleted construction. As a result, in 1993 241 construction sites and structures were sold for the total of 16.7 billion rubles. More than half of the construction (69 percent) was for social use (e.g., clinics and schools) and originally belonged to the municipalities. However, many projects remain uncompleted because of unclear ownership. A June 1994 Presidential Decree has resolved some of these problems and many more projects have been auctioned to new investors for completion.

Housing Finance and Home Ownership Subsidies

Traditionally the Soviet system of housing finance corresponded to one basic characteristic—the centralized distribution of budget funds for construction of state rental housing and its free-of-charge allocation to those who meet official standards for needing improvement in their living conditions. As a result, in 1987, the share of state capital investment in housing construction amounted to more than 80 percent, while the share financed by individuals was just

This included provisions defining various categories of land ownership and use, and the scope of authority between federal and local administrative and elected branches in regulating land relationships

14.6 percent (including individual housing construction and construction of housing cooperatives).¹⁹

By 1994 the share of investment in housing construction from the federal budget was only about 5 percent, with a major portion allocated to financing housing for retired military officers.²⁰ In 1994 the share of all state investment (funded from the federal budget, budgets of subjects of federation and funds of state enterprises) amounted to 22.7 percent, while investments of private individuals reached 28.6 percent. Private corporations accounted for most of the balance.

Since the state budget was always the main source for financing housing construction (supplemented by some contributions from enterprise funds), mechanisms for the public to participate in resolving its own housing problem in Russia have been practically non-existent. Even the financing that did exist was directed at constructing new housing by individuals or cooperatives, not at purchasing of existing housing. This can be explained by the very small individual housing market in the preceding period, a market limited by numerous restrictions.

Thus, before the economic reform there was no mortgage financing system in existence in Russia in the normal sense of the term. Housing loans were not explicitly secured by the property as collateral before 1992, when the "Law on Collateral" was adopted, and eviction in the case of default was questionable. In practice, lenders protected themselves typically by having loan payments deducted from wages by employers; where this was not possible, guarantors were sought and the bank could have wages garnished for non payment.

Long-term financing of housing for the population has been the function of one or two state banks. After 1988, the only bank offering such loans was the Russian Saving Bank (*Sberbank*), which became a joint-stock commercial bank in 1991 wholly controlled by the state (the majority of shares belong to the Central Bank of Russia). *Sberbank* is the only joint-stock commercial bank in the country where depositors' money is protected by the state.

Sberbank offered long-term financing for housing for:

- | Individual citizens for single-family homes (construction, reconstruction and rehabilitation);
- | Housing construction cooperatives (for construction); and
- | Individual citizens for garden cottages and seasonal houses in the country (building, purchase, repair).

National Economy of the USSR in 1990: Annual Statistics." Moscow, "*Finansy I statistika*", 1991, p.187.

Calculated using the data of the Goskomstat of Russia and the Ministry of Finance of the Russian Federation.

Table 7 The bulk of financial resources went toward financing new housing construction. Table 7 shows data on two types of financing in 1988-1994. It should be noted that, before 1993, only fixed-rate loans were offered in the Russian housing finance system, and only thereafter did Sberbank shift to adjustable rate loans.

| Loans for individuals for housing construction | | | | | | | |
|--|------|------|-------|-------|--------------------|------------------|------------------|
| Number of loans originated ('000s) | 73.4 | 53.1 | 124.4 | 98.4 | 120.1 | 101.3 | -- |
| Loan volume originated (millions of roubles, current prices) | 681 | 438 | 1,296 | 2,127 | 21,611 | 200,200 | 217,000 |
| Loan term (years) | 50 | 50 | 20 | 25 | 20 | 10 | 10 |
| Interest rate (percent) | 0.5 | 0.5 | 0.5 | 3 | (+12) ^a | 210 ^b | 140 ^b |
| Maximum LTV | 70 | 70 | 70 | 70 | 70 | 70 | 70 |
| Loans to Housing Construction Cooperatives | | | | | | | |
| Loan volume originated (millions of roubles, current prices) | 574 | 502 | 468 | 648 | 3,805 | 18,089 | none |
| Loan term (years) | 25 | 25 | 25 | 25 | 20 | 10 | 10 |
| Interest rate (percent) | 0.5 | 0.5 | 0.5 | 3 | (+12) ^a | 210 ^b | 140 ^b |
| Maximum LTV | 70 | 70 | 70 | 70 | 70 | 70 | 70 |

There are several points to be made about the small loans volume. In 1991, the number of outstanding loans to individuals was equal to about 0.2 percent of units in the housing stock in 1990, and 0.8 percent of the single-family housing stock in 1990. Such lending constituted only 0.2 to 0.4 percent of gross domestic product. Only 7 percent of all investment in housing was covered by housing loans.

The state policy of subsidizing housing construction was characterized not only by direct budgetary expenditures on state housing construction but also by indirect subsidies in the form of interest rate subsidies. Sberbank granted such loans primarily to certain groups, in accordance with legislation and Governmental decrees, who enjoyed the right to obtain favorable or interest-free loans to construct or purchase housing. Beginning in April 1992, individuals and cooperative housing construction, the Chernobyl disaster victims, retired military officers, forced migrants and refugees, victims of political reprisals and members of their family, and so on.)

Beginning 1993 through October 1994, the interest rate on adjustable rate loans changed with the Central Bank discount rate. Since October 12, 1994 the interest rate on adjustable rate loans has been set at 140 percent (lower than the discount rate, then at 170 percent).

Data in Table 7 show that loans to individuals can be characterized as having extraordinarily long terms and carrying very low interest rates. These loans carried subsidies: the 2 percent interest rate charged until 1993 was less than the bank's cost of one-year time deposits and only 10 basis points above the official inflation rate. In 1991, the loan rate was 800 basis points below the one-year time deposit rate. Maximum loan amounts were reasonable compared with the cost of housing. The interest rate of 140 percent is paid on balances under Rub 100,000; the maximum rate of 130 percent is paid on balances over Rub 5 million.

Source: Sberbank of the Russian Federation.

When Sberbank became a commercial bank in 1991, favorable and free-of-interest loans were subsidized from the federal budget. Under the Agreement between Sberbank, the Ministry of Finance of Russia, and the Central Bank of Russia (April 1992) 12 percentage points of the 20 percent per annum interest rate was covered by the budget. Simultaneously, under Presidential Decree No. 140 households purchasing a unit through a housing cooperative which began construction before January 1992 received grants covering 70 percent of the increase in construction costs and interest rates. Subsidies were believed necessary to offset increases in

Sberbank's cost of funds at that time was about 14 percent.

house prices and interest rates associated with inflation, and also to help sustain housing affordability. Subsidies were shared equally between the Federation and lower levels of government, and limited, if any, analysis of the full cost of such subsidies was made prior to the decision to implement the programs.

Subsidies in both of the above programs are poorly targeted. There are no income, unit size, or other restrictions on eligibility. Indeed, a rich Muscovite who had received a free-of-charge unit through privatization would qualify for the loans being made by Sberbank.

By the beginning of 1993 due to the high rate of inflation the cost of funds to Sberbank increased (the interest rate on one-year deposits was 60 percent) and the portfolio of outstanding loans was generating major losses. Under another Agreement between Sberbank and the Ministry of Finance (April 1993) a new credit policy was launched which had the practical effect of stopping housing lending by Sberbank.

In order to avoid interest rate risk, Sberbank started to grant housing loans at an adjustable interest rate equal to the discount rate of the Central Bank. Though a rate change on outstanding loans does not strictly depend on any index, it is possible when the rate of the Central Bank changes for Sberbank to make adjustments as well.

The Ministry of Finance, in turn, entered into a commitment to subsidize the interest rate on outstanding favorable and interest-free loans up to the level of the Central Bank discount rate. With interest rates being extremely high these liabilities became a burden for the Russian budget. Hence, it was nearly impossible to grant new favorable and free-of-interest loans and further lending was terminated by the joint decision of Sberbank and the Ministry of Finance.²²

Beginning 1992 until the end of 1993, bank interest rates were negative in real terms, though not as negative as it might seem on comparison with the nominal interest rate. Interest on housing loans is paid monthly or quarterly and the interest rate for a given period is calculated, approximately, by dividing the annual nominal interest by the number of payments in a year (in practice the calculation technique is slightly different). For example, if the amount of nominal annual interest on a loan at the beginning of 1993 was 100 percent and payments were to be made monthly, the effective interest rate calculated on a monthly compounded base equaled 161 percent (compared with inflation rate at the same period equal to 600 percent annually).

Under the higher interest rates on the housing loans, the decrease in a number of loans for individual housing construction starting in 1993 was not very substantial. But the higher rate had a negative impact on the loans to the housing construction cooperatives, members of which were traditionally in the middle income group. In 1994 when the nominal rate reached 210-140 percent and the effective interest rate became positive in real terms, their affordability became very low; and such loans practically stopped.

Communications between Sberbank and the Ministry of Finance of the Russian Federation, January 14, 1994 and July 28, 1994.

The following example shows the amount of monthly income required in 1994 to afford the Sberbank housing loan: with a 140 percent annual interest rate and a loan term of 10 years for construction of an individual residential house with average price of 52.5 million rubles (data from Goskomstat of Russia) and a down payment of 30 percent, the required income is 14.3 million rubles per month. According to Goskomstat of Russia in December 1994 the per capita monetary income equaled 348,000 rubles per month; thus, the monthly income of an average family was 1.04 million rubles. The income at which a Sberbank loan for individual housing construction was affordable exceeded average family income 14 times.

The ratio of dwelling price to income has fallen considerably during the period 1991-1994.²³ In 1991, the ratio of average house prices to average income in Moscow equaled 120. This is prior to price liberalization and establishment of the housing market; there were few cases of housing units being purchased in the market. The ratio fell considerably during the next few years: to 46 in 1992; 24 in 1993; and 10 in December 1994. The dynamics of the ratio of housing construction costs to average household income in Moscow were more stable: 1.1 in 1991; 5.0 in 1992; 4.5 in 1993; and the same in December 1994.

In summary, the housing finance situation in 1992-1993 on the eve of the government introducing a new strategy and commercial banks searching for their place in this sector, may be characterized by the following features:

- | Limited budget resources to support the housing sector, and extremely ineffective use of subsidies;
- | High and volatile inflation rates implying great interest rate risk for long-term lending, since the banking system's liabilities were heavily concentrated in short-term accounts;
- | Grave credit risks associated with housing lending because, despite current legal provisions, there was confusion about the enforceability of foreclosure in the case of loan default; and
- | Extremely low housing affordability as well as strongly negative real deposit interest rates (with respect to the level of inflation), which make it impossible for average income earners to purchase housing for cash or to accumulate the funds for home purchase.

These factors have determined the direction of the new Government policy in the housing financing sphere, i.e., the necessity of designing new legislation for the development of long-term housing lending, and the activities of banks in testing the acceptance by the general public of mortgage lending for construction and purchase of housing.

The ratio is calculated according to the World Bank Housing Indicators methodology as the ratio of the price of a typical unit to median urban family income (the data given above is for Moscow). A standard one-bedroom unit of 52 m² total area, located in the central sector of the city, is taken as a typical unit.

The new housing financing policy, formulated almost entirely in the state targeted program *Zhilische* (summer 1993) and assumed as the base for several legislative and normative documents (1992-1994), consisted of the following:

- | Formation of market oriented long-term mortgage lending, which should lower the risk of bank operations, and increase affordability of loans for the general public; the use of a mortgage instrument for ensuring loan repayments; creation of conditions for introducing foreclosure and using it in cases when a borrower fails to fulfill his obligations; and introduction of alternative lending instruments to be used under conditions of high and variable inflation;
- | Transfer from subsidizing interest payments to a more effective system of targeted support for groups of lower- and middle-income households, in the form of up-front subsidies for construction and purchase of housing; and
- | Providing other groups, who have not accumulated necessary savings and do not enjoy the right to receive a subsidy, with the ability to accumulate funds necessary for purchase or construction of housing or for making down payments on mortgage loans.

It should be noted, that not all these objectives have been realized so far. Neither from the legislative and regulatory point of view, nor from the point of view of their implementation in practice.

The problem of foreclosure and eviction in the case of loan default remains the central problem. The basic principles of collateral relations were formulated by the provisions of the "Law on Collateral" with further elaboration in the provisions of the new Civil Code of the Russian Federation, Part 1 (October 1994). These documents provide for the possibility of foreclosing in case of loan default. However, the right of evicting a borrower's family from a residential property is extremely limited by existing housing legislation (The Housing Code of the RSFSR; The Civil Code of the Russian Federation, Part 1, Article 292), which traditionally provides citizens with extremely broad rights of using residential property and, in fact, does not allow for the eviction of a borrower and his family from a housing unit in case of loan default. By April 1995 the State Duma had almost completed the draft of the "Law on Mortgage (Pledge of Real Estate)", which will perhaps supply a compromise settlement of this problem. However, the idea of "the rights of citizens for housing" is very popular among deputies of the Duma and drafters of the Law.

In December 1993 and in June 1994 two Presidential Decrees were adopted which established the basic institutional framework and regulation principals for mortgage lending.²⁴ The decrees provide for:

- | Housing loans to legal entities and natural persons on a commercial basis, while subsidies are granted only to persons who are on the waiting-list for improved housing;

Presidential Decree, "On Development and Introduction of Non-Budget Forms of Investing into the Housing Sector," December 28, 1993, No. 2281; Presidential Decree, "On Housing Loans," June 10, 1994, No. 1180.

- | Housing loans for the acquisition and improvement of a land plot for housing construction, for construction and rehabilitation of housing, and for the purchase of housing;
- | Loan security by mortgage; guarantees on the loan provided by enterprises and organizations are encouraged, and other forms of guarantees are possible;
- | In general, the loan-to-value ratio may not exceed 70 percent;
- | Use of loan instruments with adjustable interest rates; indexation of the loan principal, and deferred payments of the borrower are also allowed;
- | Possible establishment of the Federal Agency for Mortgage lending (which would set the standards for residential mortgage lending), to act as a liquidity facility for mortgage lenders and to have the power to issue mortgage-backed securities to generate funds; and
- | Development of a system of targeted personal savings accounts and creation of a new form of securities—including so-called "housing certificates"—to attract public savings to housing construction and to protect savings from erosion by inflation.

The importance of these normative documents is twofold. First, they create new legal possibilities for lenders. Second, and more importantly, they provide clear definition for the banking sector of the new principles of housing lending, supported and promoted by the government. In Russia, these normative acts are of great importance for the creation of the mortgage lending market since the government and the President still play an important role in the regulation of banking activity.

Following the Presidential Decree in December 1993 the Russian Federation also made a sharp change in its policy for supporting unit purchase by replacing interest rate subsidies with down payment subsidies.²⁵ Subsidies can only go to those on the waiting list for housing and range from 5 to 70 percent of the price of the unit meeting the social norm (size) for the household, with larger subsidies going to families with lower incomes and more years on the waiting list. The objective of the subsidy is to assist moderate income families with the purchase of a unit: the designers recognized that lower income groups would in general have to rely upon being allocated a municipal flat and that higher income households could fend for themselves.

As far as we know, in 1994 the Federal Budget had no special appropriations for the up-front subsidies for the construction and purchase of housing (with the exception of an experimental program in an oblast described below), though regions were granted the right to use state funds allocated for housing construction for the financing of such subsidies. The Federal budget for 1995

Russian Federation Council of Ministers Resolution, "On Approval of the Regulations on Allocation of Allowances (Subsidies) Free of Charge for Construction or Purchase of Housing to Citizens in Need to Improve Housing Conditions," December 10, 1993, No. 1278.

allocates 350 billion rubles (10 percent of the total for housing construction in the federal budget) for up-front subsidies to specified groups of persons on the waiting list who are eligible for a subsidy (migrants from the Far North regions, victims of the Chernobyl catastrophe, forced migrants, and persons having the right to beneficial financing of construction and purchase of housing).

An experiment granting federal budget subsidies to retired military officers is currently being carried out in the Nizhny Novgorod oblast, and the results are most impressive. From the 4,000 families on the waiting list for housing in the Nizhny Novgorod oblast subsidies were granted to about 750 families during October-November 1994. By April 1995 about 540 families had already either bought new dwellings or had concluded an agreement for completion of construction of a unit which had previously been started but was halted after being at least 70 percent completed. Some of the families acquired housing using both the subsidy (75-85 percent of the price of social-standard housing) and their personal savings. Other families, in accordance with their credit rating, were given long-term loans by banks implementing the program. Other regions (e.g., Moscow and St. Petersburg) plan to commence providing such up-front budget subsidies in 1995 to all groups of persons on the waiting-list.

Despite many problems, there has been substantial progress in initiating mortgage lending. Banks' interest in beginning such operations appears to be driven by two factors. First is the perception of an enormous future market for mortgage loans, with the present being the time to attain a strong position for future market share. Second is pressure from the federation and regional governments to support housing construction for both countercyclical economic reasons and as a way to help address the nation's severe housing problems. In effect, lenders have been finding ways, sometimes with the assistance of the government, to cope with the various risks (credit risk, interest rate risk) and a few have actually begun lending operations in 1993 and 1994.

The Mortgage Standard Bank (Moscow) was one of the first (in mid-1993) to originate long-term mortgage loans for housing to employees of large enterprises (KAMAZ, "Yava" tobacco factory). In May 1994 Mosbusinessbank, the third largest commercial bank in Russia in terms of assets, started long-term mortgage loans for the purchase of housing on a commercial basis to its employees. In 1994 one of the largest banks, Menatep, granted about US\$2 million in loans for the purchase of housing to its employees and the general public, and is currently originating approximately 10 loans per month.

A March 1995 telephone survey of Moscow firms involved in the "sale of housing on an installment plan" (which in fact consists of granting a long-term bank loan for the purchase of housing) found that more than 300 such loans are being made in Moscow every month.²⁶

On August 12, 1993 the Association of Russian Mortgage Banks was organized. It is registered with the City of Moscow as a public (i.e., non-profit) organization having education and other trade association objectives. The Association's creation came at the initiative of the Joint

The survey was conducted by A. Tkachenko, consultant to the Urban Institute. During February-March, 1995, 19 companies which advertised their activity in the mass media were polled.

Stock Mortgage Bank and the St. Petersburg Mortgage Bank. There were seventeen founding members, including ten banks. The banks include eight commercial banks with "mortgage" in their name. These banks are located in Moscow (two), Ufa, St. Petersburg, Rostov-on-Don, Kuban, Saratov, and Novosibirsk. New banks continue to join the Association.

The Association is an active participant in the legislative process. Perhaps most important is the development of its training function in cooperation with USAID-funded program, executed by the Urban Institute and Fannie Mae. Given the lack of experience with mortgage lending in Russia, the availability of high quality training is essential to the development of a sound industry.

As was noted above, the Russian market tried to adapt to inflationary economic conditions and unfavorable legislation by finding its own means of lowering different types of risks involved in long-term lending and increasing the affordability of loans to households so that they could borrow enough funds to make a significant contribution to purchasing the unit. Let us consider the four main directions along which innovation has occurred.

n Interest Rate Risk. The most difficult problem faced by banks is make lending profitable in the face of severe interest rate risk (because of the decidedly short-term structure of its liabilities) while at the same time making loans affordable to borrowers.

Banks making mortgage loans are addressing interest rate risk through new loan instruments: Sberbank has shifted to a variable rate mortgage, with the interest rate defined as the Central Bank discount rate; Mosbusinessbank has adopted the DAIR, which measures the cost of funds by using the interbank lending rate as a base for the indexation of loan principal; and the Nizhni Novgorod Kredit Bank and Join-Stock Mortgage Bank in Jaroslavl have implemented an instrument which indexes the loan principal to an index based on the official minimum monthly income.

Dollar-denominated loans have become the most widespread instruments. Under these, all loan terms are defined in U.S. dollars with a fixed interest rate, but the borrower makes regular payments in rubles at the current exchange rate. Results of a telephone survey shows that Moscow commercial banks mainly use this type of loan (Stolichny Saving Bank, Alpha Bank, Neftyanoy Bank, Menatep, for example).

By employing different indexes banks are attempting to match changes in the price of bank liabilities to changes in interest rates on originated loans. Meanwhile, due to a lack of official information on market interest rates, banks are trying to interpret these standards in a public-friendly way. However, approximations cannot fully prevent interest rate risk, since U.S. dollar exchange rate fluctuations and, even more, the discrete political decisions on changing the minimum wage value do not coincide with changes of the market interest rates.

Banks originating dollar-denominated loans are trying to protect themselves from interest rate risk by assigning high interest rates (30-35 percent annually). Thus banks are charging nominal loan interest in hard currency plus implicit interest equal to the index of the U.S. dollar exchange rate. Such a high real interest rate gives banks a large cushion to absorb losses from mismatches between movements in the exchange rate and interest rates.

In May 1994 Mosbusinessbank began to originate loans using the Deferred Adjustable Instrument for Russia (DAIR).²⁷ This instrument uses a cost-of-funds index, enabling the shift of most or all of the interest rate risk away from the lender to the borrower. The DAIR employs two interest rates:

- l A "payment rate," i.e., the rate of interest used to compute what the borrower pays each month (typically in the range of 5-10 percent); and
- l A "contract rate," which is used to compute what the borrower owes.

The contract rate for the DAIR could be, for example, the interbank lending rate plus additional charges for risk, administration, and profit. The difference between the amount owed and the amount paid each month is added to the loan balance. Payments due are recalculated quarterly using the new loan balance, and the amortization period is reduced each quarter to force the loan to close on time.

The objective in designing the DAIR was to have a rate of return competitive with other opportunities available to the bank; operationally this was taken to be the interbank lending rate. Hence, the profitability of the DAIR is similar to the bank making a series of short term loans (the whole period being equivalent to the mortgage loan period) in the interbank market. The DAIR, as designed, would yield about 140 percent of the interbank rate, and it appears to carry a quite acceptable credit risk.

n *Loan Affordability.* Indexed instruments used by banks make it possible to reduce annual interest rates down to 5-10 percent (DAIR), or 30-35 percent or even less (dollar-tied loans); this compares with the 140 percent interest rate offered by Sberbank. The Jaroslavl subsidiary of the Mortgage Joint-Stock Bank, using the minimum wage index, allocates loans with a 26 percent fixed interest rate. Thus, these instruments are enabling the borrower to increase the size of the loan that is affordable given his income. With these instruments the full interest payments are captured later in the life of the loan because the loan principal is indexed to the U.S. dollar exchange rate index or a cost-of-funds index. Thus, these instruments shift some of the increased interest payments required on the loan into the future when the borrower will better be able to pay them because his income will be higher.

Affordability of a mortgage depends to a great extent on its term. Russian banks making mortgage loans normally issue 10-year loans (Mosbusinessbank, Jaroslavl Subsidiary of Mortgage Joint-Stock Bank, Mortgage Standard Bank). Banks issuing loans through realtor entities in 1994 gave a 1-2 year term.

In 1995 Stolichny Saving Bank, working with the "Universal Financial Company," offered 10-year dollar-denominated loans with an interest rate lower than for short-term loans. For example, a 3-month loan carried a 27.5 percent annual interest rate; a 2-year loan, 25.0 percent;

Ravicz, M., and R. Struyk (1993). *The Deferred Adjustable Instrument for Russia (DAIR) Product Description*. The Urban Institute: Washington, DC.

a 10-year loan, 19.5 percent. Nevertheless, the result was quite unexpected: customers proved to prefer short-term loans (1-2 years). This is perhaps a reflection of the instability of commercial enterprises and the distrust of customers towards them.

n *Credit Risk.* The principal source of credit risk is the inability to provide the proper enforcement of the security of the loan, i.e., foreclosure of the loan and eviction of the borrower. Only a few banks actually originate mortgage loans based on a credit contract signed with a borrower and secured by a mortgage agreement (Mosbusinessbank, Jaroslavl subsidiary of the Incorporated Mortgage Joint-Stock Bank, and some others).

The most widely used scheme is the so-called "selling of dwelling by installments" based on a lease agreement signed with a borrower with a provision for eventual purchase (i.e., a lease-purchase agreement). This method is used in Moscow by Stolichny Saving Bank, which began issuing loans in 1994. Universal Financial Company, realtor companies including "Housing Initiative", SAVVA, "BANSO" and others have acted as partners with Stolichny Savings Bank in this venture. This method is also used by another triple union comprising the commercial bank "Neftyanoy," the joint stock company "Neftyanoy—Real Estate Company," and the realty company "Krasniye Vorota".

The main provision of this scheme are as follows:²⁸

- 1 The client applies to the realty company regarding purchase of a unit. The company can assist a client in finding the necessary dwelling, or the client can choose it himself. The realtor verifies legal title of the unit and guarantees it, as well as making a commitment to assisting the client to obtain a bank loan for its purchase. The company charges a fee for its services (5-8 percent of the dwelling price, depending on the term and other provisions of the loan and the firm's practice).
- 1 The bank originates a loan to the borrower for purchasing an apartment through a dollar-denominated loan. Loan repayment is made monthly with payment of interest and partial repayment of the loan principal, excluding short-term loans (3-6 months) when the loan principal is paid upon expiration of the loan period. The loan to value ratio is 67 percent for 2-year loan, 60 percent for 3-5 years, and 50 percent for 6-10 years.
- 1 In case of a delay in payment for the period exceeding the agreed term, the bank is entitled to terminate the agreement on its own initiative. In this case, settlement with the borrower is rather strict. Only 50 percent of the down payment is paid back (in some cases none is paid back), plus payments on the loan principal to date (considering the high rate of inflation, the value of this settlement is much depreciated).

Some features of the scheme vary among lenders. The example described above is for the Stolichny Saving Bank based on results of a telephone interview with the joint stock company "Universal Financial Company" and on the article "Instead of Mortgages, Large Banks are Attracting Customers with Housing Loans," E. Makovskaya, *Commersant Weekly*, No. 9, March 14, 1995. Additional data were provided through an interview with a representative of the firm "Krasniye Vorota."

- i The key participant in the scheme is the finance company, which purchases the selected unit for itself. For the bank this company acts as a borrower's guarantor and in case the borrower fails to pay back the loan, the guarantor is responsible to pay the outstanding loan. At the same time this company concludes an agreement with a realty firm, stipulating the obligation of the realty firm to buy back the apartment at 25-30 percent discount, if it is necessary in case of a loan default.

The finance company concludes with the borrower a housing lease agreement with an option of eventual purchase; this is the basis on which the borrower occupies the apartment until the final repayment for the loan. Upon the final payment the borrower becomes the owner of the apartment. In practice, the lease agreement is concluded for a one-month term with an option to extend, if payment is made. If the borrower fails to pay in time, the lease agreement is terminated and the borrower evicted from the apartment, the financial company sells the apartment to the realty firm and pays off the loan. The finance company charges a fee for its services in the amount of 3.5 percent of the price of the apartment.

As for the borrowers using this mechanism, they are normally independent businessmen and employees of commercial companies. Borrower underwriting does not normally go further than the personal judgment of an interviewer. Moreover, the lender is not very interested in the paying capacity of the borrower, since in the case of non-payment the bank will get its funds back from the guarantor who will sell the dwelling to the realty firm.

The transaction of taking this loan is very expensive for the borrower. Including the bank's service fees of 4 percent of the apartment price, and a 1.5 percent fee for property insurance (in the case of loans for 3 or more years), such a deal costs a customer 14-17 percent of the price of the purchased unit. These amounts are not returned in case of non-payment. Notwithstanding such strict lending terms, such arrangements are expanding due to the great demand for housing loans.

n *Funds Mobilization.* Banks have different approaches to the problem of mobilizing funds for originating housing loans. One option is the opening of targeted residential savings accounts. Joint Stock Mortgage Bank of Moscow was one of the first to provide its shareholders with the ability to open such an account in March 1994. The minimum savings period is one year and the borrower must save not less than 30 percent of the price of the unit. Installment payments to the account are made in rubles, but the funds are indexed to the ruble-dollar exchange rate. On accumulating the necessary amount, the customer has the right to obtain a dollar-denominated mortgage loan for a term of 1 to 10 years. The amount of the loan depends on the borrower's ability to make monthly payments.

The Moscow branch of Sberbank implemented such a program in February 1995.²⁹ Savers can purchase housing units (constructed by the "Miks" construction enterprise) in the Moscow region. The accounts are in a hard currency with a 5 percent annual interest with annual compounding. With a minimum saving term of 6 months, the customer has to accumulate not less

E. Makovskaya, "Instead of Mortgages...", *Commerzant Weekly*, No. 9, March 14, 1995.

than 50 percent of the price of an apartment in a low rise building or a single-family unit (\$30,000-\$250,000 per unit under the current prices). Units are supposed to be built within 6-12 months. The construction is financed by a dollar-denominated credit line from Moscow Sberbank with 10 percent annual interest, which is very attractive, since the interest is considerably lower than that on the market.

After saving the necessary amount of funds in the housing accumulation account, the customer has an opportunity to move into a newly erected house, and the remaining amount is paid to the construction enterprise "Miks." The terms of payment have not yet been determined; it is only known that the schedule of payments is calculated for 10 years, and until the loan is paid in full, the dwelling is the property of "Miks."

Some banks are trying to solve the problem of obtaining resources for loans by selling loan obligations. For example, in mid-1993, Mortgage Standard Bank (MSB) began long-term lending operations with a single large enterprise, the truck manufacturer Kamaz. MSB originates and services loans made to the enterprise's workers who are purchasing new units. Ten-year loans are made. The bank sells the loans at par back to Kamaz or a sister organization; Kamaz bears the credit risk. About 2,000 loans were originated in 1993, and a total of 12,000 are scheduled by the end of 1995. Thus, the bank obtains originating and servicing experience while avoiding most of the risks of mortgage lending. Kamaz is able to produce additional housing for its workers at no greater cost than it did under the former arrangement of constructing rental housing. In this case, however, Kamaz has no responsibility for maintaining the units, as it would for rental housing.

The principle of working closely with an enterprise in providing owner-occupied housing to its workers is a sensible one, and one that banks in other countries have employed successfully. This version is not as robust as it might be, however. Our understanding is that MSB is not underwriting the loans, but rather simply lending to the workers presented by Kamaz. Hence, the bank is gaining no practice in underwriting. Moreover, the bank's incentive to service delinquent loans aggressively is clearly not very great under these arrangements. On balance, it is possible that the bank may be developing poor lending habits rather than valuable experience.

Banks expect that the creation of the Federal Agency on Mortgage Lending will open a new permanent source of loan funds. The issue of participation of state and interested major commercial structures in the creation of the Agency is under discussion in the Government. The Agency is supposed to buy from banks residential mortgage which meet the Agency's standards of quality; then it will issue its own securities, backed by these loans. The issue of providing the Agency's securities with guaranties by the Government of the Russian Federation in order to make them more attractive for investors (pension funds, insurance companies, investment funds and individual investors through them) was also under discussion in the spring of 1995.

While banks increased the interest rates on loans sharply during 1993, there was no corresponding movement on rates paid on deposits. A few small banks offered higher rates, but Sberbank, which continued to account for nearly 90 percent of all household deposits, at the end

of 1993 was paying an annual rate of 100 percent with compounding only taking place on an annual basis.³⁰ In this environment households energetically searched for higher paying options.

One response from the market was the creation of a kind of real estate investment trust. This scheme is operating in at least ten large Russian cities (including Moscow, Nizhniy Novgorod, Samara and others), and more schemes are being created monthly.

Real estate trusts are used by private investment and construction companies (for example, financial and construction company Povolzhskaya in the city of Samara was one of the first to use this approach). The trusts attract public funds for housing construction by concluding special housing contracts or issuing bonds, bills, and other securities. Very often the oblast administration is the main participant, acting as an issuer of so-called "housing loans" and housing bonds (Nizhegorodskaya Oblast, Ulianovskaya Oblast, the cities of Moscow and St. Petersburg have filled this role).

The main steps in the procedure are as follows:

- | The issuer issues certain "housing certificates,"³¹ which have, in some form, two nominal values: one in square meters of total area of housing (for example, 0.1 square meters, or 0.2 square meters) and the other in the price of this square meter (sometimes construction cost, in some cases the market price);
- | The "saver" buys housing certificates for a certain issuing price, which reflects the changes of construction cost (or market price) of one square meter of housing;
- | The "saver" who buys enough certificates to equal the number of square meters in the total space of an apartment, has the right to claim such an apartment as the redemption of his certificates;
- | The certificates may be put into circulation, and the issuer establishes certain rules for their repurchase at some indexed nominal value, with the terms of such repurchase varying from simple return of the initial nominal value of the certificate to a slightly discounted current selling price of the certificate, denominated against the current construction cost index or the market price for housing, or the Central Bank discount rate;

In May 1994 Sberbank offered a new form of deposit with monthly compounding interest rate of 12 percent (monthly inflation was 6.9 percent). The rate was later lowered, but was still positive in real terms until September 1994. In March 1995, the interest rate on similar deposits was set at 7 percent monthly (in Moscow, 8 percent), corresponding to a 150 percent annual effective rate; annual inflation at that time was 178 percent.

There are many different forms of such securities. We will use the term "housing certificate" as described in the Decree of the President of the Russian Federation "On Issuing and Circulation of Housing Certificates."

- | Conscientious issuers generally use the attracted funds for housing construction, sometimes for the purchase of housing in the market, and for placing part of the funds into bank deposits or state securities for the purpose of gaining profit or maintaining the liquidity of the certificates;
- | Two types of issues are distinguished: short-term (1.5 or 2 years) and long-term (10 years). In the first case the certificates are mainly connected with the construction of a specified housing unit³² and in this case the volume of issue for the certificate is equal to the planned volume of housing construction. In case of long-term issues there are no such specific provisions;³³ and
- | To sustain the investors' trust in the certificates, and promote their liquidity, many private issuers attract large commercial banks as guarantors for the issues of the certificates; similarly, when the oblast administration acts as the issuer, the securities are guaranteed by the oblast budget.

In 1994 27 bond issue prospectuses were registered in the Ministry of Finance of the Russian Federation totaling 500 billion rubles (roughly US\$250 million). They were issued by different executive bodies of Subjects of the Federation.³⁴ The majority of them are residential (housing) loans.

Many reputable private companies attract oblast administrations to act as guarantors. This is in response to the fraudulent activities of many firms, which attract funds from the public through different forms of securities, speculating on the lack of housing and offering enormous returns, backed by nothing. In the majority of cases such investments have led to disastrous results.

In June 1994 a special Presidential Decree³⁵ was issued in order to regulate these housing construction securities. The decree has the objectives of ensuring targeted use of these funds, ensuring their safety and protection from inflation, and ensuring a high degree of liquidity. This decree introduces the following requirements and limits for issuing of housing certificates:

For example, in January 1995 the Ulyanovsk oblast administration began issuing the second oblast housing loan to finance the construction of three 10-storey residential buildings, consisting of 80, 120 and 200 apartments, in the city of Ulyanovsk.

For example, the state housing loan for the Nizhny Novgorod oblast was issued with a term of 10 years. Its placement was assisted by a commercial entity: the Nizhny Novgorod Property Foundation, which organizes the process of loan placement and disbursement. The first loan funds will be used for the uncompleted housing projects of the Joint Stock Company. GAZ; these projects are about 50-90 percent complete.

M. Lanzman. "Municipal Authorities on the Stock Market," *Segodnya*, December 27, 1994, No. 247 (354).

Decree of the President "On Issue and Circulation of the Housing Certificates," June 10, 1994, No. 1182.

- | The procedure of indexation of nominal value of housing certificates is to be determined when it is issued and noted on the certificate; and it must remain unchanged during the entire term of the security;
- | Only legal entities who have the right of the customer for housing construction (or their successors), the right to an allocated land plot and a complete set of documents for the construction of housing and the issuing of securities can act as an issuer of these certificates;
- | The value of the securities issue in terms of floor space of housing may not exceed the total area of the housing under construction which is being built with the attracted funds;
- | For concluding a sales and purchase agreement for an apartment with the issuer, the purchaser need only buy the number of certificates corresponding to 30 percent of the floor space of the apartment; the owner of certificates may pay back the balance in some other way, including through loans;
- | Housing certificates should be redeemed within seven banking days in accordance with the procedure of indexation of the nominal value by the issuer or by the guarantor with whom the issuer must conclude the corresponding agreement; a bank or an insurance company may act as a guarantor;
- | Certificates of one issue may be exchanged for the certificates of new series without changing the nominal value of the original certificates (of certain types and similar location) and without additional charges; and
- | Registration of the issue prospectus for the certificates with the appropriate state agency is obligatory.

However, since the Ministry of Finance and the Ministry of Construction of the Russian Federation have not elaborated the corresponding regulations in support of the Decree, these various procedures for the issuance of certificates are still not mandatory. As described, this scheme appears to be reasonably safe and likely profitable for the company and advantageous for the saver today compared with other savings instruments available in Russia. A key point for its being successful is that the funds raised be actually invested quickly in real estate whose value will move with the construction cost index.

However, if a firm offering such contracts relies solely on the funds generated in this way to finance the construction of the units, and if the number of savers equals the number of units in the building, then there is a good chance of the building's completion being greatly delayed. Obviously, other sources of funds are necessary—including commercial bank loans, bonds sales, and others.

Table 8 It seems likely that households will have a difficult time actually using the certificate mechanism to purchase a unit, certainly in the short term. Thus, the possibility of exchanging one issue of certificates for those of a new issue is important.

| | 1990 | 1991 | 1992 | 1993 | 1994 |
|--|------|------|------|-------|-------|
| Number of units privatized ('000s) | 10.5 | 44 | 122 | 2,612 | 5,804 |
| Percent of eligible housing privatized | 0.03 | 0.13 | 0.4 | 7.6 | 17.1 |
| Annual | 0.03 | 0.13 | 0.4 | 7.6 | 17.1 |
| Cumulative | 0.03 | 0.16 | 0.6 | 8.2 | 25.3 |

Source: Goskomstat of the RSFSR.

Rental Housing

Privatization of State Rental Housing

The first steps toward privatization of the housing stock were taken in 1988 (see Table 8), when fully paid-off apartments in housing cooperatives were turned over to the ownership of citizens. After one year the process was expanded to include sale of units to tenants of state and public housing. However, through the end of 1990, the privatization process had met with very limited success: only about 54,000 units had been privatized.

In June 1991, the Supreme Soviet of Russia passed the law "On Privatization of the RSFSR Housing Stock". It established a new procedure for transferring state and municipal housing into the private possession of tenants. The main provisions of this law were:

- 1 Apartments were turned over to the private ownership of their properly registered tenants;
- 1 The right to privatization under privileged conditions could be used only once; and
- 1 Tenants were issued a "voucher" without fee, the value of which was calculated from the value of a single square meter of the "average apartment" in their city multiplied by a norm of freely transferred square meters.

This law did not significantly increase the speed of privatization—during 1991 only 122,000 units were privatized.

In December 1992 the Supreme Soviet made fundamental changes in the Law on privatization of housing in the Russian Federation which simplified the privatization procedures and increased the housing stock subject for privatization:

- 1 The procedure for appraisal of an apartment and its repayment was abolished: housing was now transferred into ownership without charge regardless of the total floor space;
- 1 Attestation of the application by a notary was not required, no state duty for privatization of housing was to be charged;

Table 10 Owners of the housing stock and organizations having housing in their full economic management (typically municipalities and enterprises) were granted the right to pass decisions on privatizing residential quarters allotted for the period of employment and communal apartments; and

| Income quintile | 1992 | 1993 |
|------------------|-------|--------|
| Lowest quintile | 7,556 | 6,766 |
| 2nd quintile | 7,885 | 8,646 |
| 3rd quintile | 9,068 | 11,898 |
| 4th quintile | 9,232 | 13,038 |
| Highest quintile | 9,840 | 13,244 |

Privatization of housing in blocks in need of rehabilitation was permitted, with the former lessor retaining his obligations for rehabilitation of the block. The beginning of the "era of free privatization" was marked by a dramatic increase in the share of privatized sector (see Table 9). However, by the middle of 1993 the process slowed down, and this pattern continued through 1994. While in early 1993 more than 700,000 housing units were being privatized every month, in late 1994 this number had dwindled to about 150,000 units per month.

Analysis of the characteristics of privatized units and the social structure of citizens who privatized their housing (Tables 10 and 11) shows that the process of privatization was concentrated mainly in the following sectors of the housing stock:

- 1 Housing occupied by pensioners, primarily single persons, for whom privatization means the chance to give the property to their heirs; and
- 1 Housing with potentially high market value (reflected both in the quality of the flat and building as well as location (both regional and metropolitan) of the unit).

For instance Table 10 shows that units privatized in Moscow in 1992 are clearly more valuable, except among the lowest group, which is dominated by pensioners who have a strong motivation to privatize.

It seems evident that the potential for privatization, in its present form, is exhausted. For those who do not expect marked advantages from privatization in the near future, a positive decision is largely offset by negative incentives. First, tenants enjoy very strong rights: they are almost impossible to evict, even for non-payment of rent; and they have the right to bequeath the occupancy right of their unit to adult children or grandchildren registered as living in the unit. Thus, gains in tenure security from privatization are minimal. In addition, the poor condition of the housing stock in tenement houses is a deterrent—taking a unit is essentially receiving the right to pay for future rehabilitation. Moreover, uncertainty about the cost of the new property tax and future fees for maintenance. (During the transition period, the time period of which is not defined in the legislation, the rates of payments of the owners of privatized housing for maintenance and repair of housing and for utilities are practically equal to 2/3 of the rates for municipal housing.)

Table 11 Moscow Privatization Participation by Socioeconomic Group 1993

| | 1992 | 1993 | 1994 |
|--|-------|-------|--------|
| Percentage of eligible households (thousands) | | | |
| Adult(s) with children | 2,612 | 5,804 | 27,396 |
| Privatized units (cumulative), includes: | | | |
| Single householder | 366 | 616 | 118 |
| Adult(s) with children | 2,790 | 8,393 | 10,949 |
| Privatized units (cumulative), includes: | | | |
| Single householder | 366 | 616 | 118 |
| Adult(s) with children | 2,790 | 8,393 | 10,949 |
| Percentage of eligible stock privatized, includes: | | | |
| Single householder | 8.46 | 25.5 | 31.32 |
| Adult(s) with children | 13.3 | 28.3 | 31.9 |

The practice of charging commercial rents for municipal housing is not being developed, though

the necessary legal basis is given in the Russian Federation law "On the fundamentals of the federal housing policy." The reason is that currently it is possible for any renter to privatize the state housing unit he occupies (after which its operation is paid for by the rates established for social housing).

Rent Policy

"Rents" in the Russian context consist of two components that are charged and paid separately. Until 1994 maintenance fees had remained unchanged since 1928 and cost a maximum of 16.5 kopecks per square meter of living space.³⁶ Charges for communal services are computed separately for about a dozen different services. Of these, only electricity and telephone usage are monitored for individual units. Charges for communal services have been raised fairly frequently in the last few years; charges for some of the less important items now cover full cost. Energy prices to residential users remain far below world levels.

In 1992 and 1993 tenant payments made a wholly insignificant contribution to the costs of providing services. Moscow officials estimated that they covered less than 1 percent of maintenance costs at the end of 1992 and even less in 1993. This contrasts with 35 percent in 1990. A similar picture emerges from data on tenants expenditures. In March, 1992 the average tenant devoted about 2 percent of its income to rents (maintenance fees and communal services); for the poorest 25 percent of the population, these expenditures accounted for only 4.2 percent of income. By November 1993, the poorest households spent only 0.8 percent of their income on housing.³⁷

Local governments have adjusted in three ways to the sharp reduction in total costs covered by tenants: cutting services, increasing subsidy payments from their budgets, and imposing a new tax on enterprise turnover to pay for housing maintenance. Nationally, in 1992 funded maintenance budgets were sufficient to cover only 25-30 percent of estimated requirements. In Moscow in 1993 the figure was 45 to 50 percent. Even so the City still devoted about 17 percent of its total budget to existing municipal housing: 2.8 percent for current maintenance; 10.1 percent for capital repairs, and 4.1 percent for communal services subsidies. If maintenance services had been adequately funded, they alone would have accounted for 6 percent of the City's budget. Deferred maintenance is piling up, which implies additional capital repairs in the future.

The Law on Fundamentals passed in December 1992 requires that rents be raised to fully cover operating costs within a five year period; local governments are required to introduce housing allowances for social housing at the time of the initial rent increase. During the five year

Beginning in April 1991 it was possible for local Soviets to increase maintenance fees and a few—such as the one in St. Petersburg—did.

The figure on the share of income spent on housing is from Struyk, Kosareva et al. (1993); parallel data for 1993 are from the author's calculations using data from the monthly household income and budget survey conducted by Mosgorstat for November 1993. The figure on the share of total costs covered by tenant payments was provided by the City of Moscow Department of Engineering and Communal Services.

Table 12 State support for capital repairs is to continue. The Government's Program "Housing" makes clear that raising rents to market levels is the eventual goal.

| Year | Percent of Operating Costs to be Covered by Rents | Maximum Share of Income to be Paid for Rents |
|------|---|--|
| 1994 | 15-20 | 10 |
| 1995 | 20-40 | 15 |
| 1996 | 40-60 | 20 |
| 1997 | 60-80 | 25 |
| 1998 | 100 | 20 |

Notes At least four reasons can be advanced for the Government rejecting a "shock therapy" approach to raising rents.

^a Payment for housing meeting the social norm for households of a given size and composition (see text below).

^b An amendment to the Decree has made this schedule optional to the regions; the goal of 100 percent cost coverage by 1998 remains. Most regions are attempting to follow the schedule.

- | There are severe data limits for a faster approach. Perhaps most importantly, no one knows what it costs to maintain housing in the Russian Federation. Official cost estimates may overstate actual costs, leading to further inefficiency. There are also enormous uncertainties about developments in maintenance and communal services costs and incomes in the years ahead. The step-by-step approach permits adjustments to the original plan to be made as needed.
- | The step-by-step approach permits more time for increases in income. Hopefully within the five year period, real income increases will result from productivity gains; in addition, cash incomes will rise as workers receive more of their total compensation in cash rather than in in-kind services.
- | Housing allowances are the first income-tested program in Russia of any scale or sophistication. The step-by-step approach controls the volume of participants and gives the time needed to perfect administrative procedures. An immediate increase to full cost coverage would result in essentially universal participation, meaning three million participant households in Moscow. The jump to full cost coverage would also result in about the same net (after allowance payments) increase in rent revenues as a smaller increase, because after a moderate increase allowance payments are required to pay all of the additional rent increase.

The housing allowance payments are to be made using a "gap formula":

$$S = MSR - t*Y$$

where:

- | S is the subsidy payment to the tenant;

- | *MSR* is the "maximum social rent," i.e., the fees for maintenance per square meter of total space plus the payment for the "normatives" of communal services times the number of square meters defined as the social norm for a family of a given size and composition;
- | *t* is the share of income deemed reasonable for the family to spend on housing; and
- | *Y* is household income.

Thus, the allowance covers the gap between the cost of an adequate accommodation and what the family can reasonably afford to pay. The household pays the full cost of housing above the MSR (i.e., for extra space occupied), creating a clear incentive for low income, overhoused families to move to smaller units.

According to the Government Resolution, the right to the housing allowance is granted to individuals living in the state or municipal housing stock under the "naim" contract. At the same time the state bodies of the Russian Federation can extend this right to other categories of population (e.g., those having privatized their apartments). The first year of housing allowances implementation has shown that the majority of the regions expanded that right to all categories of the population.

The main results of 1994—the first year of reforming the system of payments for housing and utilities—may be summarized as follows:

- | Most of the regions increased the rates for housing and utilities payments to cover 20 percent of costs. In actual practice this resulted in a ten-fold (on average) increase in the amount of rent charged.
- | Persistently high inflation quickly "swallows" the existing current level of cost coverage. To maintain this level, payment rates for housing and utilities had to be reviewed several times during the year (in many regions—once a quarter). In Moscow payment rates for housing and utilities were calculated in terms of 15 percent cost coverage (as of early 1994); however, they were only introduced starting on August 1 and had not been reviewed till the end of the year. Hence, by the end of 1994 payments for housing and utility collected from the Muscovites covered only 3-4 percent of actual expenditures.
- | Across Russia, there was a ten-fold variance in the level of housing and utilities charges for similar units. For a standard two-room apartment, these payments ranged from 4,000-5,000 rubles in a number of South European regions of Russia up to 40,000-50,000 rubles in the cities of Siberia and Far East. To some extent, this can be explained by the difference in the expenditures for utility services (primarily, for heating), but a certain role was also played by the fact that the more conservative administrations of East European Russia chose a "moderate" scheme for the reform of the system of housing and utilities payments.

Table 13 In 1994 the key program parameters of the social standard of housing space and Housing Allowance Program Participation Rates, 1994

| Reason for Failure to Apply | | Share of Eligible Households Failing to Apply for Housing Allowances (percent) | |
|--|--|--|----------|
| | | Vladimir | Gorodets |
| In the present social and economic situation, the program parameters adopted mean that more of the families can make common maintenance and utilities payments without exceeding 10 percent of their total income. On average, during the second part of 1994 Russian families spent 3-6 percent of their income for the housing and utilities payments. In regions with lower rates for maintenance and utilities payments (including Moscow), the number of families who have applied for housing subsidies in 1994 amounted to 0.1 percent for all families. In cities with a high level of maintenance payments and tariffs, by the end of the year housing subsidies were requested by more than 3 percent of families. | | 78.3 | 68.5 |
| Did not know of subsidies | | 8.9 | 22.4 |
| Did not believe was eligible for subsidy | | 8.9 | 22.4 |
| Amount of subsidy not worth applying for | | 0.9 | 0.7 |
| Did not know where to apply | | 3.0 | 0.0 |
| No answer | | 0.0 | 0.0 |

At the same time calculations show that even at the current level of housing and utilities payments and household income, the number of families who had actually applied for the subsidy was 5-10 times less than the number of families eligible. A survey carried out in Vladimir and Gorodets (Nizhny Novgorod Oblast) revealed a worrisome picture: by October 1994 subsidies were requested in Vladimir by only 2.1 percent of the families having the right to receive them, and in Gorodets by 3.6 percent of eligible families. We are worried by the reasons for which people fail to apply for the subsidy (Table 13); by far the most frequent reason was that people had not heard about them.

Similarly, in December 1994, two-thirds of Moscow households had not heard about the housing allowance program. Thus, in all these cities, despite the promotion campaign in the local press, TV, radio and other means, most of the population did not receive or recognize the program information being disseminated. This can partly be explained by the small amount of the subsidies and the relatively low value of housing and utilities payments at the time of the survey.

In 1995 most regions were planning to raise the cost coverage by rents to the 20-40 percent level, with the value of t increased to 12-15 percent. Forecasts for Moscow (which has already defined the main parameters for the reform of housing payment system in 1995) indicated that in the first part of 1995 about 172,000 families (more than 5 percent of the total) shall be eligible for the subsidy. During January-March 1995 about 100,000 Moscow families applied—about 60 percent of forecasted pool of eligible households. The city of Nizhny Novgorod is expected to have about 100,000 eligible families, of which about 55,000 (10 percent of all households) applied and were processed by the end of March 1995. During this period, the average monthly amount of the subsidy equals 10,000-12,000 rubles (about US\$2-3).

Policy on Private Rental Housing

The size of the private rental stock is still very small, despite the absence of rent controls. Professional realtors assume it is about 5 percent of the housing stock in Moscow, 1-2 percent of the stock in St. Petersburg, and less than 1 percent in other major cities. However, it could be substantially higher in small urban or rural settlements, mainly in the form of renting out rooms in individual houses.

The Urban Institute household survey in Moscow in December 1993 identified 1.4 percent of households surveyed as private renters. Also 0.6 percent of families reported they rent out a room in their flat. The characteristic features of the private rental stock can be summarized as follows:

- | *Very low supply.* The potential demand is much higher than the number of units physically available. This results in rent levels comparable with the most expensive Western cities. The monthly rent for a two-room flat of modest quality varies from US\$1,000 or more in the center of Moscow to US\$350 in the outskirts.
- | *Non-existence of private lessors as a class.* Lessors are mostly those families who managed to get two or more flats under the old system of housing distribution. Thus, the sector remains extremely volatile as long as it is driven by both market forces and family needs. Only recently a small share of lessors have made rents the main source of their income and started substantial investments in rehabilitation or modernization. However, there is another potential source for a private lessor class. Some industrial enterprises were privatized with their housing stock, which they now own outright. Those enterprises tend to use the obtained dormitories as something between hotels and private rentals. A similar process occurs within the departmental housing stock (enterprises and government agency housing), though the legal basis there for renting the units is even weaker.
- | *Low legal standards.* The private rental sector emerged from subletting of municipal or departmental units by their legally registered occupants. This was almost always illegal because the law demands rents should not exceed those in municipal or state housing stock—a situation which seldom obtained. A significant portion of the state housing stock is still being rented at market-level rents alongside private rental housing. As a result, both lessor and renter in state-owned housing are unprotected. Most rental agreements are still carried out verbally. The lessor protects himself by demanding prepayment (from 3-4 months to 1-2 years ahead).

In summary, a fundamental transformation of the rental sector is underway. The phased increase in rents will stimulate the reallocation of existing housing from overhoused poor families to those with greater effective demand. The poor are, however, protected from excessive rent hikes by housing allowances when they occupy units consistent with their household size. Simultaneously, a private rental market is emerging, one that is being fed by the high rate of unit privatization.

Conclusions

The three years of economic reform (1992-1994) have been characterized by significant results in the housing sector:

- | The principal concept of setting up of the housing market in Russia has been developed with creation of the main legislative and regulative basis to support its proper functioning;
- | One of the main achievements of the housing reform is formation of a significant social group of housing owners as a result of free privatization; at the moment 53 percent of the housing stock belongs to private owners;³⁸
- | The effectiveness of market relations in the housing construction industry and the notable response to the elimination of barriers imposed against people willing to solve their own housing problems have been confirmed by the stability of individual housing construction compared with the deteriorating official construction industry;
- | Under circumstances of high inflation and inadequate legislative protection for mortgage lending, banks in Russia managed to perform skillfully in developing new approaches to long-term housing lending;
- | Authorities managed to begin the reorganization of the system of maintenance of the municipal and state housing stock on the basis of self-financing through scheduled rent increases commencing in 1994—the first increases since 1928).

Though there are many problems still requiring solution, specifically legislative support of the reform and, particularly, its practical implementation, the rapid start in Russia has created hope for its successful completion.

Government of the Russian Federation. Program "Reforming and Development of the Economy in Russia in 1995-1997 (Draft)" Moscow, March 1995.